

Private Letter Ruling: Lump sum distribution of partnership retirement payments exempt from self-employment tax is exempt from Illinois income tax.

November 20, 2003

Dear:

This is in response to your letter dated September 25, 2003 in which you request a Private Letter Ruling. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 86 Ill. Adm. Code Section 1200.110 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to Mr. Z for the issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that you are not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

This correspondence is requesting a ruling on the Illinois Personal Income Tax treatment of a 2003 transaction.

Taxpayer : Mr. Z – see address above SS # XXX XX XXXX

Ruling Requested:

It is requested that a ruling be issued that the income to be earned by the retire partner taxpayer in 2003 qualifies as a subtraction Modification to adjusted gross income per 35 ILCS 5/ Article2 Section 203 (b)(2) F, retirement payments to retired partners. The 2003 income includes monthly partner retirement payments from the partnership, the cost of a fixed annuity to be purchased by the partnership for the partner in defeasement of a portion of its retirement pay obligation and a related lump sum cash settlement paid to the retire partner during 2003.

Facts:

The taxpayer retired from the partnership in 1999. In accordance with the partnership retirement agreement, the partner is entitled to monthly retirement payments of \$ X per month for the remainder of the partner's life. There is no survivor benefit. The retirement plan payments are not funded or in trust and are made from the general assets of the partnership generated from on going operations. All of the retirement payments are excluded in computing net earnings from self-employment by Section 1402 of the Internal Revenue Code and regulations adopted pursuant thereto. Retirement payments have been subtracted as modifications to adjusted gross income in prior retirement years for Illinois Individual Income Taxes under 35 ILCS 5/ Article2 Section 203 (b)(2) F.

In response to changes in the independence rules related to audit services to clients imposed by recent Federal legislation and the SEC, the partnership has disposed of various consulting business segments of the practice. Also in recognition of the unsecured and unfunded nature of the pension liability to its retirees partners, the partnership has concluded a plan which is intended to defease a portion of the retired partner retirement obligation using in part the cash proceeds from the sale of the various consulting practices. Retired partners have

individually been given an opportunity to exchange some, all or none of their existing right to future retirement payments for a fixed annuity which will be purchased and paid out over the lifetime of the taxpayer retired partner. For Federal Income Tax purposes the entire cost of the fixed annuity and additional cash payments to the retire partner will be included in the retired partner's gross income in 2003. All of this Federal adjusted gross income will be excluded in computing net earnings from self-employment by Section 1402 of the Internal Revenue Code. The taxpayer has requested that approximately 45 percent of the retirement pay due the retired partner in future years be converted into the fixed annuity obligation. Thus in 2003 the taxpayer will have received as retirement pay to a retired partner monthly retirement payments, the purchased fixed annuity and a lump sum cash settlement.

In 2004 and future years the taxpayer will continue to receive a reduced monthly retirement payment from the partnership (approximately 55 percent) and monthly annuity payments from a private insurance company. Only the payments from the partnership will be a subtraction modification for Illinois Individual Income Tax. The annuity payments will be taxable in accordance with the Internal Revenue Code, some portion being taxable income and some portion be the actuarially determined non-taxable return of cost basis. The taxpayer would not make a subtraction modification for the taxable portion of the annuity payment received.

Discussion

Illinois statutes have provided for a subtraction modification for retirement payments to retired partners. In the case at hand the retired partner will have an inclusion in Federal Gross Income in 2003 of amounts that in effect represent a lump sum 2003 distribution of retirement payments that would be due in all future years as actuarially determined. Federal code requires that the entire cost of the fixed annuity purchased in the name of the retired partner be fully taxable in the year of purchase. The fact that there is immediate taxation of this amount for Federal purposes should not change the nature of the payment as being a retirement payment to a retired partner.

Illinois law does not provide for a subtraction modification for annuity payments in retirement unless specified in sub paragraph F of Section 203(b). The taxpayer will thus be taxed for Illinois Income Taxes on the federally taxed portion of all subsequent annuity payments. Thus failure to grant the requested ruling with respect to treatment of the 2003 income would result in double inclusion in income for Illinois when the substance of the 2003 transaction is clearly a retirement payment. The only change has been an acceleration of payments in the form of a more secure annuity investment, which will generate future retirement income.

Conclusion

The taxpayer respectfully feels that the ruling requested is clearly within the language and intent of the statute. Therefore, the 2003 partner retirement income included in Federal gross income should be allowed as a subtraction modification for Illinois Personal Income Taxes.

Ruling by Department

Section 203(a)(2)(F) of the Illinois Income Tax Act ("IITA," 35 ILCS 5/101 et seq) states as follows:

- (a) Individuals
- (2) Modifications. The adjusted gross income referred to in paragraph (1) shall be modified by adding thereto the sum of the following amounts:

...

and by deducting from the total so obtained the sum of the following amounts:

...

(F) An amount equal to all amounts included in such total pursuant to the provisions of Sections 402(a), 402(c), 403(a), 403(b), 406(a), 407(a), and 408 of the Internal Revenue Code, or included in such total as distributions under the provisions of any retirement or disability plan for employees of any governmental agency or unit, *or retirement payments to retired partners, which payments are excluded in computing net earnings from self employment by Section 1402 of the Internal Revenue Code and regulations adopted pursuant thereto;*

Emphasis added. The relevant paragraph of Section 1402 of the Internal Revenue Code reads as follows:

(a) Net earnings from self-employment.--The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in [section 702\(a\)\(8\)](#) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

(10) there shall be excluded amounts received by a partner pursuant to a written plan of the partnership, which meets such requirements as are prescribed by the Secretary, and which provides for payments on account of retirement, on a periodic basis, to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death, if--

(A) such partner rendered no services with respect to any trade or business carried on by such partnership (or its successors) during the taxable year of such partnership (or its successors), ending within or with his taxable year, in which such amounts were received, and

(B) no obligation exists (as of the close of the partnership's taxable year referred to in subparagraph (A)) from the other partners to such partner except with respect to retirement payments under such plan, and

(C) such partner's share, if any, of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in subparagraph (A);

According to your letter, your 2003 income will include "monthly partner retirement payments from the partnership, the cost of a fixed annuity to be purchased by the partnership for the partner in defeasement of a portion of its retirement pay obligation and a related lump sum cash settlement paid to the retired partner during 2003". The monthly payments are "monthly retirement payments of \$ X per month for the remainder of the partner's life" and are clearly excluded in computing net earnings from self employment by IRC Section 1402. These payments are therefore eligible for subtraction as a modification to adjusted gross income pursuant to IITA Section 203(a)(2)(F).

Your letter indicates that the other two sources of your 2003 income are a result of a change in circumstance based on the sale of various consulting practices of the partnership. These payments are in exchange for your right to future retirement payments that would have come from the disposed consulting practices. Furthermore, you state that "[a]ll of the retirement payments are excluded in computing net earnings from self-employment by Section 1402 of the Internal Revenue Code and regulations adopted pursuant thereto."

Based on your representation that these payments are all properly excluded under IRC Section 1402, it is our conclusion that all three sources of 2003 income discussed above are eligible for subtraction as a modification to adjusted gross income for Illinois individual income tax purposes.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Sincerely,

Heidi Scott
Staff Attorney -- Income Tax